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Capital formation and its financing are strategic not only for long-run economic change, but also for the short-term fluctuations that affect the short-term course of a country's economic activity — its business cycle. As long known, capital formation fluctuates during business cycles with a far wider amplitude than does flow of consumer goods.

Simon Kuznets, *Capital in the American Economy*,
Princeton University Press, 1961

DENIAL

If confidence and optimism were enough to keep an economy growing, the U.S. economy would never have stopped booming. To be sure, the former ridiculous euphoria about a new paradigm economy creating all kinds of wonders is gone. But regarding the poor reality of the past three years, we can only express our utter amazement about the optimism that still generally prevails, though apparently with one great exception — corporate bosses.

Statistics showing sharply rising stock sales by corporate insiders over the past couple of months suggest that the bosses of Corporate America regard the current stock rally as a great selling opportunity. We happen to share this view.

Comparing the U.S. economy's dismal performance over the past three years with the prior glowing descriptions of future new paradigm prosperity, one might well have expected some drastic change in the general perception of the U.S. economy.

Well, the former, glowing "New Era" talk is gone. Yet there remains a striking aura of optimism. The recent *Investors Intelligence* survey of investor sentiment shows bulls at 58.7% and bears at 16.3%, reportedly the best reading since the spring of 1987.

In his book *Irrational Exuberance*, Professor Robert J. Schiller writes: "*There are times when an audience is receptive to optimistic statements and times when it is not.*" We guess that Americans are, typically, inclined to focus on the bright side of things, while Europeans tend to focus on negative implications. Yet the New Era delirium that seized the American public during the past several years was also most unusual for America. It had its only parallel in the New Era euphoria of the 1920s. For us, this has always been the one precedent to look at for clues.

Ever since the 2001 recession ended, American policymakers, economists and international organizations have been forecasting the U.S. economy's imminent recovery. The U.S. economy's downturn during the year was generally hailed as the mildest in history, essentially to be followed by a prompt recovery.

There was, indeed, a recovery in 2002. However, apart from slowing during the year, it proved, above all, a rather badly mixed bag, with consumer spending accounting for 88% and government spending for 32% of real GDP growth. This was definitely a pattern of growth that had nothing in common with that of sustained cyclical recoveries in the past.

New pronounced economic weakness that has developed in the course of last winter was readily attributed to public worries about the threatening Iraq war, with the implication, of course, that a quick victory there would promptly revive spending spirits. But the postwar snapback has not materialized. While economic data appear mixed, improvements are a rarity. Overwhelmingly, they point to more weakness.

Considering this persistent failure of the U.S. economy to accomplish the expected recovery, the persistent bullishness as professed by consensus forecasters and the stock market keeps puzzling and amazing us. We presume two main causes:

One cause is a general indifference to the particular, structural causes of this economic downturn; and the other is great, if not blind, faith in the effectiveness of monetary and fiscal demand stimulus.

The result is chronic confidence, or rather overconfidence, leading to denial. What we read from most American economists conveys the impression of a general, strong belief in the magic of confidence as the purveyor of crisis and prosperity, as against a gross neglect of the objective facts that make for economic crisis or recovery. Paraphrasing a famous remark by economist Joseph Schumpeter about the causes of a crisis, we want to emphasize the following:

No great economic recovery has ever come about that was not fully explainable by the objective facts of the situation. Expectation not so conditioned never has produced more than short-lived spurts of breaks. And this is true not only for general business situations but for any particular market.

AN UNEXPECTED CULPRIT — OVERCONFIDENCE

In *Major Recessions*, a book we highly appreciate, the author, Christopher Dow, makes a few remarks about the role of confidence and overconfidence in an economy's performance that stick in our mind. In essence, he expresses the view that recessions are basically a reaction to an excess of confidence built up in the previous boom. In other words, overconfidence is the problem, not the solution.

We have consciously and critically followed the economic developments in Europe and America over the whole postwar period. In actual fact, by far the best years for both continents from the perspective of economic growth, wealth creation and rising living standards were the 1950s and the 1960s.

Both productivity and profits rose at record rates for two decades. Yet, looking back, it strikes us that neither in Europe nor in America did this cause any exuberance, rational or irrational. Year after year, economic and income growth exceeded prevailing, modest expectations. On both continents, policymakers, economists and the public took this brilliant economic performance in stride, regarding it as just normal. The stock market, as a matter of fact, played no role at all in the economic thinking of policymakers and the public. Stocks were supposed to reflect what is happening in the economy.

In hindsight, the 1970s appear to have been the American economy's most dismal postwar years. At the decade's end, the inflation rate seemed out of control. In 1979, for the first time ever in peacetime, consumer prices rose at a double-digit rate of 12%, followed in 1980 by 13%. But by 1986, the rate was down to just 4%, even though the economy had been booming.

Facing virtual panic over inflation, then-Fed Chairman Paul Volcker was able to pursue a policy of dramatic monetary restraint. But a great and pleasant surprise was to follow: Once the Fed loosened its savage credit crunch in 1982, the economy took off in steep strides with real GDP growth rates of 3.9% in 1983 and 6.2% in 1984, remaining at an annual rate of around 3% and higher until 1988.

THE SUPPLY-SIDE DELUSION OF THE 1980s

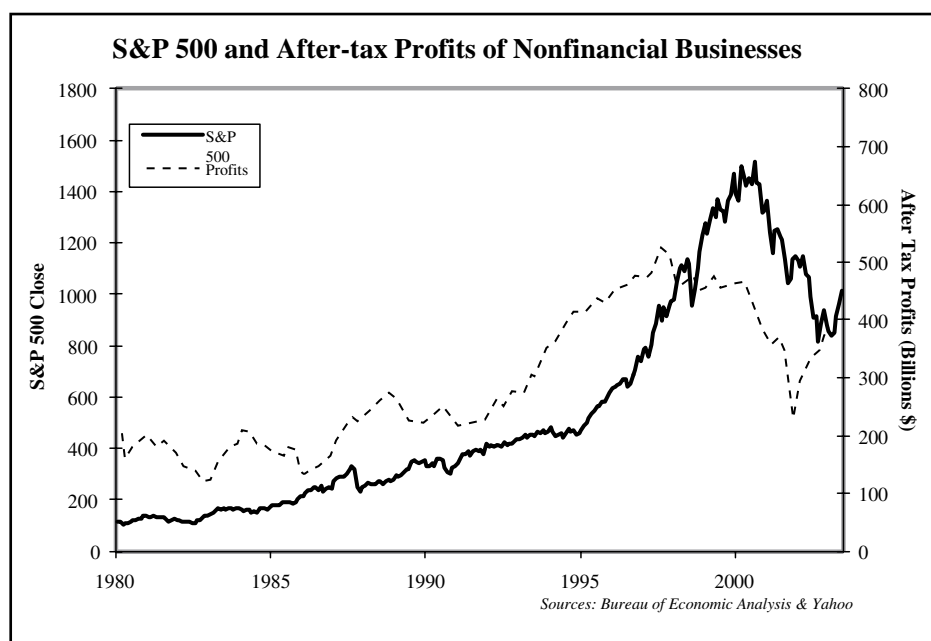
Measured by real GDP and employment growth, the U.S. economy's performance in the 1980s definitely exceeded prior expectations. In particular the apparent new ability to combine sharply accelerating economic growth with sharply falling inflation rates was hailed as a sensational achievement and taken as compelling evidence that supply-side Reaganomics was duly working miracles on the economy.

Soaring U.S. stock prices and a sudden phenomenal rise in the dollar from 1980 to early 1985, after its prior prolonged, steep decline, reflected and generated unprecedented optimism about the U.S. economy, inviting at the same time contemptuous comparisons with protracted, anemic growth of the "sclerotic" economies in Europe.

On the surface, supply-side Reaganomics seemed a sounding success, but only on the surface. The predicted investment boom never happened. What fuelled the economy's sudden burst of growth was an unprecedented consumer borrowing and spending binge. Actually, an exploding budget deficit together with a sharp fall in personal

saving slashed net national saving to an unprecedented postwar low. It was the beginning of the U.S. economy's chronic current-account deficit, reflecting a persistent excess of consumer spending over earned current income.

Supply-side economics is, in essence, supposed to strengthen the economy's supply side through higher saving, investment and profits. What actually happened in the 1980s was, quite dramatically, the exact opposite. The one GDP component that drastically outpaced the growth of the others was consumption. Essentially, it did so mainly at the expense of net business fixed investment and the trade balance. Paradoxically, while stock prices soared, business profits went nowhere, falling even steeply as a share of GDP. In the same vein, net national savings and net business fixed investment, as a ratio to GDP, declined to postwar lows.



Looking at postwar America, both the 1980s and the late 1990s stand out as periods of high-riding expectations, systematically whipped-up by policymakers and Wall Street economists. In the 1980s, the catch for the public was the coming economic wonders from the new supply-side economics. In the 1990s, the new catch was coming economic wonders from the new information technology and radically improved corporate governance.

In retrospect, the 1980s were America's first postwar encounter with general, irrational exuberance and a bubble economy. It effectively worked across the whole economy through another feature that is

conspicuous for irrational exuberance — a general stampede into credit and debt.

From 1982 to 1989, consumer borrowing surged by 114%, or an average of 16.3% per year. Business debts soared at the same time by 101%, or 14% per year.

Normally, businesses borrow to invest in plant and equipment, but this changed radically during the 1980s. Businesses borrowed overwhelmingly not to invest in new plant and equipment but to finance rapidly escalating transactions — mergers, acquisitions and stock repurchases. While corporate debts exploded, corporate holdings of tangible assets declined compared to the economy's size. In essence, it was a stampede into financial manipulation and unproductive debt.

What deluded most people about the disastrous development in the economy's capital formation was the fact that the GDP statistics showed a substantial rise in gross fixed investment. It was overlooked that a drastic shift in the investment pattern toward capital goods with a shorter life was implying sharply rising depreciations, also by the way at the expense of corporate profits.

Between 1980–90, depreciations on nonresidential fixed investment soared from \$231.7 billion to \$484.7 billion, or 109.2%, while net fixed investment inched up from \$129.2 billion to \$145.6 billion, or 12.7%. As a share of GDP, net fixed investment fell to a postwar low.

MORE OF THE SAME IN THE LATE 1990s

We have briefly revisited this episode of the 1980s because there are many striking parallels in the pattern of economic and financial excesses and dislocations that were to follow in the late 1990s. Yet there is one

tremendous difference between the two episodes. That is in the magnitude of the credit excesses and the economic and financial imbalances that they created. They have been running and keep running in dimensions that defy reasonable imagination.

Remarkably, the bubble of the 1980s ended with a soft landing for the U.S. economy and its financial markets. There followed a prolonged period of slower economic growth, including a brief recession in 1991, during which annual real GDP growth averaged 2.3%. From the conventional perspective, this was a dismal economic performance.

From the perspective of *quality* of economic growth, however, the U.S. economy in these years performed at its best in three decades. Most remarkably, too, this happened against the backdrop of drastically slower money and credit growth. From 1989 to 1994, business debts grew just \$204.3 billion, or 5.6%, as against an increase in consumer debts by \$1,214 billion, or 36%.

At the same time, there developed three outstandingly positive features:

- (1) Before-tax profits of the nonfinancial sector shot up from \$237.2 billion to \$496.1 billion in 1997;
- (2) Net fixed investment surged from \$97.8 billion in 1992 to \$407.3 billion in 2000;
- (3) The U.S. current-account deficit virtually stagnated. In 1996, after temporary improvements, it was little higher than in 1989.

This highly positive development in profits, net fixed investment and the trade account had its inflection point in 1998. Even though the economy was booming, profits suddenly sagged.

Looking for extraordinary changes in the pattern of the economy's development, we notice two things: exploding credit and an exploding current-account deficit.

	U.S. Inflection Point 1998 (Billions \$)				
	1996	1997	1998	1999	2000
Nonfederal, nonfinancial credit	588.3	781.3	1,095.0	1,128.7	1,149.8
Credit of financial sectors	550.1	662.2	1,087.2	1,073.3	809.0
Current-account deficit	117.8	128.4	203.8	292.8	410.3

Source: Federal Reserve Flow of Funds; Council of Economic Advisors: Economic Indicators

For us, the critical fact to see is that in 1997–98 the credit expansion in the United States went completely out of control. Implicitly, this created imbalances in the economy and the financial system, and the most immediate and the most obvious one was the surging trade deficit.

THE SINGLE BIGGEST DRAG ON THE U.S. ECONOMY

As we have already pointed out many times, the huge and swelling import surplus is probably the most important and also the least understood depressant of the U.S. economy. American policymakers and economists have usually hailed it as an emblem of the U.S. economy's superior economic growth and the harmless counterpart of foreigners wishing to invest in the United States.

This is true in a mechanical sense, just as money inflows into the stock market always equal money outflows. But the fact is that this simple equation overlooks the tremendously harmful economic and financial implications of such a deficit.

Assessing the impact of a \$500 billion trade deficit has to start with the recognition that for American producers this huge amount represents an equal amount of forsaken revenue from domestic spending that is instead accruing to foreign producers.

But that is not all. Most of the dollars being spent on goods and services at home or abroad come from the domestic earnings of their spenders, in other words, from the wage bill of American businesses.

True, in past years these outflows have promptly returned in the capital account through the current account of the balance of payments. Insofar they have offset each other in the balance of payments. But there is a crucial difference between the two flows in their economic impact. The outflowing money buying foreign goods or services directly depletes available domestic income, including profits, while the inflowing money only buoys America's asset markets, adding nothing to the U.S. income circulation.

Considering the tremendous drag the trade deficit keeps exerting on domestic income creation in the United States, we think that it is the single greatest obstacle to a recovery of the economy.

FIGHTING EXCESS WITH MORE EXCESS

From the beginning, it was Fed Chairman Alan Greenspan's publicly declared intention not to prick America's stock market bubble with rate hikes, as Japan's central bank had done in 1990, but rather to fight the fallout of its burst. He has been doing this now with great energy for almost three years. In essence, this intention implicitly meant to fight the consequences of excessive monetary ease with still more excessive monetary ease.

In a way, he has been most successful. Since he started his rapid and drastic monetary easing in early 2001, nonfinancial credit and debt has literally exploded by about \$3 trillion and financial sector credit and debt by another \$2.5 trillion. Total indebtedness (nonfinancial and financial) is now surpassing 300% of GDP, up from 256% at the beginning of 1998. Financial sector borrowing has almost doubled during this period, to \$10.6 trillion.

Another striking result of the Fed's persistent monetary looseness is that instead of the one stock market bubble that has partly burst, it has kindled three new bubbles: (1) a house price bubble; (2) a mortgage refinancing bubble; and (3) a heavily leveraged bond bubble that has driven bond yields and quality spreads to postwar lows.

As to the stock market bubble, corporate equity at market value directly held by private households hit its peak in 1999 with \$9,017 billion, coming from \$4,137 billion in 1995 and \$2,548 billion in 1991. At the end of the first quarter of 2001, its market value had plunged to \$4,165 billion, implying a total loss of \$4,880 billion, or 54%.

But these losses were largely, though not fully, offset by gains in the market value of tangible assets, mainly housing, rising from \$10,403 billion in 1999 to \$13,889 billion in 2002. The net worth of private households over these three years has declined from \$42,188 billion to \$39,313 billion. Since this net worth was only \$21,943 billion in 1991, it is widely argued that private households are effectively in excellent financial shape.

REAL WEALTH AND PHANTOM WEALTH

Judging by these numbers, America is enjoying unprecedented, fabulous wealth creation. For the old economists, wealth creation occurred essentially and exclusively in the economy through saving and investment in tangible assets, such as the construction of buildings and manufacture of business equipment, adding to the economy's capital stock and productive power. In essence, this kind of wealth creation boosts both demand and supply.

These economists distinguished strictly between such wealth creation in the economy through saving and investment and the creation of financial wealth in the markets, either through rising market valuations or through the creation of paper securities, which are not backed by the creation of physical assets, like government debt.

Such financial wealth creation clearly represents wealth for their owners. But from a macro perspective, it is phantom wealth that hurts society as a whole in the long run. While enriching some people, it impoverishes the economy as a whole if it boosts consumption at the expense of investment and the foreign trade balance.

With this distinction in mind, we took a look at wealth creation during recent years in the United States. Between 1991–2002, private households in the United States saved altogether \$2,602 billion from their current income, accounting for about 15% of the increase in total private wealth. Around 85% accrued from the rising market values of existing assets.

We think this explains a lot about the U.S. economy and the thinking of policymakers and economists. It is a novelty in economic thinking that rising market valuations are considered full-fledged wealth creation. In the case of house prices, it used to be called inflation.

ANOTHER BUBBLE

Mr. Greenspan has been hailing the wonderment of the U.S. economy's new resilience to the bursting of the stock market bubble and the various shocks from terrorists and the Iraq war. But its true cause is obvious. What, for the time being, has prevented a deeper and longer recession in the United States is more and more of the very same consumer borrowing and spending bubble that has been propelling U.S. economic growth over the past several years.

Yet two things have changed. The first one is the collateral behind the consumer borrowing and spending binge. Rising stock prices have been replaced by rising house prices. The second one is that it needs more and more rampant credit and debt creation to master just marginal GDP growth.

Our highly critical assessment of the U.S. economy's performance during the past two to three years, in fact, has a major reason in the atrocious discrepancy that has developed between extremely promiscuous monetary and fiscal stimuli and their extremely poor economic effects.

Between 2000 and 2002, the federal budget has swung from a surplus of \$295 billion into a deficit of \$257 billion, heading for a \$400–500 billion deficit in 2003. During the same two years, total nonfinancial credit zoomed \$2,520 billion and financial credit by another \$1,879 billion, both adding up to \$4.4 trillion.

And what was the effect of this credit and debt deluge on the economy? GDP during these two years grew in real terms by \$248 billion and in nominal terms by \$621 billion. To us, this is an outright policy disaster.

WHAT NEXT?

American consensus economists are definitely consistent in their approach. Undeterred by data that overwhelmingly point to enduring weakness of the economy, they stick to the same forecast of the U.S. economy's imminent, strong recovery. Though there is no trace of the generally predicted postwar snapback, optimism about the U.S. economy and its imminent, strong recovery remain the order of the day.

Betting on the government's third tax cut, further Federal Reserve easing, a weaker currency, and still more mortgage refinancing, the consensus expects economic growth to accelerate to 3–4% in the second half of this year, compared to the dismal sub-2% in the first half.

In striking contrast, Mr. Greenspan and the Fed have become distinctly more cautious in their utterances about the economy's prospects. The Fed's latest *Beige Book* admits that economic activity remains sluggish. Although "*the unwinding of war-related concerns appears to have provided some lift to business and consumer confidence*," the report said, "*the effect has not been dramatic*."

Consumer spending was said to have "*remained lackluster*." Labor markets were described as "*weak*" and manufacturing activity as "*mixed*." In particular one remark in this report concerning consumer spending shocked us: "*Overall consumer spending was soft in April and May. Retail sales picked up some after subdued sales in March, but most reports indicated that sales remained below the level of a year ago*."

This weakness in consumer spending, in particular, makes to us most ominous reading, considering that new borrowing and mortgage refinancing are setting ever-new records. Both new and existing home sales rose to record highs last year with mortgage origination totaling \$2.5 trillion. According to estimates by the Mortgage Bankers

Association, mortgage origination this year is set to reach even \$3 trillion, with over \$1.7 trillion of refinancings.

Assessing the effects of this mortgage-refinancing binge, it is necessary to distinguish between two effects. One is the change in net new borrowing by the consumer. It rose by a record amount of \$768 billion during 2002. The other effect is the savings that the private households make through the refinancing of existing mortgages on their interest payments. Considering that 30-year fixed rates for mortgages have plunged by more than two percentage points over the past 12 months, from well over 7% to almost 5%, these savings have played an important role in bolstering disposable consumer incomes.

Pondering where all this money went, we took a look at the pattern of consumer spending from 2002's first quarter to 2003's first quarter. What we found greatly surprised us.

Apart from a temporary, minor surge in the sale of motor vehicles, expenditures on consumer durables were flat over the year. Among nondurable goods, the major increases in spending were on food, gasoline and fuel. Actually, 63% of the higher consumer spending was on services, and mainly on housing and medical care.

It was a discovery that has shocked us because we learned that the American consumer's heavy borrowing is largely financing expenditures on essentials.

NO CHANCE FOR AN INVESTMENT RECOVERY

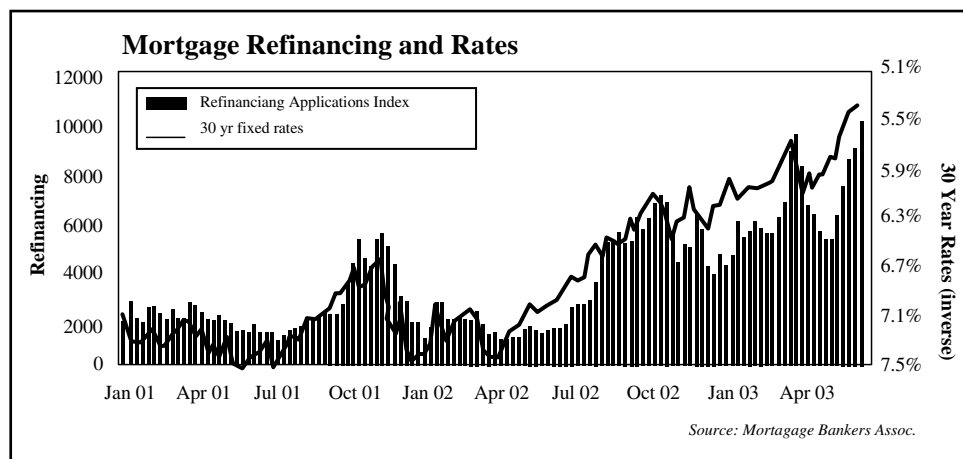
The other negative conclusion to be drawn from these facts is that consumer spending, despite ever-new records in borrowing, is not able to lead a sustained recovery. So far it has prevented a deepening recession, but it is much too weak for more than that. The obvious indispensable further condition for sustained, stronger economic growth is higher business fixed investment. Mr. Greenspan has certainly realized this, having said in a recent speech, *"the central question about the outlook remains whether business firms will quicken the pace of investment."*

Scrutinizing the GDP numbers and also the necessary conditions for a broad recovery in business fixed investment, we see no chance for it to happen. But first a clarification of facts:

Over the 12 months to the first quarter of 2003, nonresidential fixed investment has declined in nominal terms by \$21.7 billion and in real terms by \$17.6 billion. The decline occurred across the board, but it was centered in structures, that is, in nonresidential buildings.

Business investment on equipment and software, measured in current dollars, increased slightly, by \$10 billion, or 1.2%, implying virtual stagnation. Measured in real terms, however, one item, computers and peripheral equipment, showed a sharp increase by \$56 billion, or 21%. For many bulls it is one ray of hope in the economy's overall dismal picture. In reality, it is nothing but hedonic pricing. In current dollars, business spending on computers rose by just \$4.4 billion.

Pondering the possibility of a broad recovery in business capital investment, we can only repeat what we have stressed many times before. Profit prospects are the key question in this respect. But scrutinizing the various macroeconomic components that ultimately determine aggregate profits, we note a preponderance of



negative influences. The greatest potential threat to profits is a return of private households to higher savings that is sure to happen when the mortgage refinancing frenzy abates and when long-term interest rates stop falling.

Positive influences from the macro perspective during 2002 were the sharply widening federal budget deficit and rising residential building. Major negative influences were the continuous rise in the trade deficit and declining net investment, mainly due to the continuous rise in depreciations.

The fact is, there are no reasonable signs of an imminent pickup in U.S. economic growth in general and of business fixed investment in particular. In the last analysis, all the prevailing optimistic forecasts are based on the conviction that the Fed and government have the infallible means to generate a recovery under any circumstances. The chorus calling for the Fed to open its money spigots further has become deafening.

ARE CENTRAL BANKS ALMIGHTY?

The people who expect a double dip or worse in the United States certainly represent a small minority. Among policymakers and economists in America, it is a virtual consensus view that the Great Depression of the 1930s as well as Japan's present, protracted economic quagmire have their decisive cause in one crucial policy mistake: Both central banks were much too slow in lowering their interest rates when the economies began to weaken.

All this really boils down to one key question: When do central banks make their decisive mistake? Is it during the boom and the bubble? Or is it in their aftermath?

Convinced he had learned from history, Mr. Greenspan slashed the Fed's federal funds rate with unprecedented speed from 6.5% to just 1.25%. Establishing thereby a steeply sloped yield curve, his aggressive rate cuts had sweeping effects also on long-term rates, as investors and speculators stampeded into highly leveraged purchases of higher-yielding longer-term bonds.

In principle, central banks have but two instruments at their disposal to influence money and credit growth with the ultimate aim to curtail or to stimulate economic activity: adjustments in bank reserves through open market operations; and adjustments in its key short-term rate or rates.

Yet there is still a third, unconventional instrument of which central bankers have made very different or no use of at all. It has sometimes been called a central bank's open mouth policy. Mr. Greenspan is definitely the world's one central banker who has practiced this extraordinary tool with unusual abundance and aggressiveness. He, apparently, regards it as perfectly legitimate for a central banker to bend expectations in the economy and the markets in a direction he wants.

During America's boom and bubble years, he was effectively the most prominent and also the most pronounced New Era Apostle. In various speeches, he developed arguments or "theories" plainly rationalizing and fanning the euphoria in the stock market.

In his famous Boca Raton, Fla., speech on Oct. 28, 1999, just a few months before the stock market's crash, he suggested that the unprecedented equity valuations seemed to be the appropriate response of investors to the economy's advanced information technology:

The rise in the availability of real-time information has reduced the uncertainties and thereby lowered the variances that we employ to guide portfolio decisions. At least part of the observed fall in equity premiums in our economy and others over the past years does not appear to be the result of ephemeral changes in perceptions. It is presumably the result of a permanent technology-driven increase in information availability, which by definition reduces uncertainty and therefore risk premiums. The decline is most evident in equity risk premiums.

But how long can we expect this remarkable period of innovation to continue? Many, if not most, of you will argue it is still in its early stages. Lou Gerstner (IBM) testified before Congress a few months ago that we are only five years into a thirty-year cycle of technological change. I have no reason to dispute that.

Having learned nothing from his past blunders, Mr. Greenspan is at it again. To quote Fed mandarin Vincent Reinhart: *"The Federal Reserve has always appreciated the importance of correctly aligning market expectations."* Putting it rather more bluntly, *"to manipulate market expectations in the direction that the Fed desires."*

BLOWING NEW BUBBLES

During the late 1990s, Mr. Greenspan was keen to foster the stock market bubble by aggressively manipulating both market rates and market perceptions. This time, he is keen to foster the three new bubbles that he has kindled in fighting the burst of the stock market bubble — the house price bubble, the mortgage refinancing bubble and the bond bubble.

Together, they are plainly indispensable for maintaining some zip in consumer spending.

But among the three bubbles, one is of crucial importance because it drives the other two. That is the bond bubble. Refinancing activity tends to pick up significantly whenever mortgage rates drop below previous lows. Importantly, Treasury yields guide the movements of mortgage rates. In essence, it was the sharp drop of Treasury yields over the past two years that led the simultaneous, steep decline of mortgage rates. The recent, renewed sharp drop in Treasury yields gave mortgage refinancing another strong boost.

Within barely six weeks, 10-year Treasury yields have plunged from close to 4% to close to 3%. In sympathy, mortgage rates fell to 5.21%, the lowest rate in more than four decades.

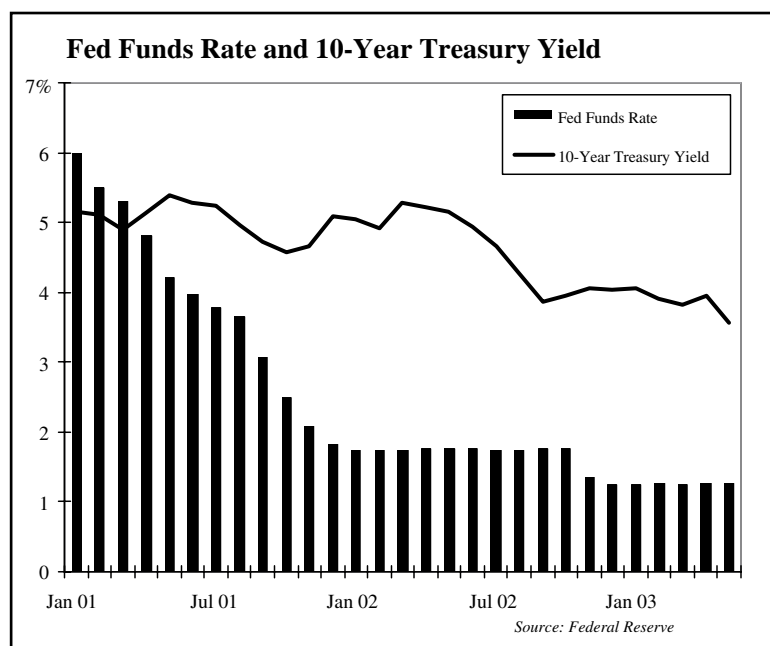
The astonishing thing about this sudden, new decline in market interest rates was that it happened at a time when the stock market was, on the contrary, being carried upward by spreading hopes for the economy's imminent recovery. What happened to make this new, sharp decline of longer-term interest rates possible?

In its May 29 editorial, *The Wall Street Journal* praised the Fed chairman for his wily gamesmanship. *"Merely by talking about deflation, he's made the markets anticipate easier money; long term interest rates have fallen accordingly, helping to keep housing prices afloat and to spur one more round of home mortgage-refinancing. This in turn feeds consumer confidence and helps keep the post-bubble economy growing. As a monetary gambit, uttering the word deflation has so far been a great tactical success. We suppose that's worth the price of scaring people about an economic threat that isn't very likely."*

In short, being assured by Mr. Greenspan and other Fed members that there would be no interest rate hike as far as the eye can see, investors and speculators, desperately hungry for big profits, stampeded into heavily leveraged bond purchases, giving through the sliding yield a new strong boost to mortgage refinancing.

Closer to the truth: In the guise of worrying about the evil of deflation, Mr. Greenspan signalled to the marketplace his determination to accommodate unlimited leveraged bond purchases. Investors and speculators complied with enthusiasm, giving long-term rates another sharp downward tick. Implicitly, in a country with negative national savings, any decline in market interest rates can only come from financial leveraging.

In this way, the last bit of restraint on financial leverage and speculative excess in the markets was effectively removed. Endless liquidity is available for the taking by the speculating financial community. The



obvious result is a credit and bond bubble that meanwhile vastly outpaces the excesses of the equity bubble.

The benchmark Treasury 10-year note hit a 45-year low of close to 3%. Junk bonds, which carried 13% yields last October, now yield about 9% on average. But the particular fun in playing the yield is, of course, in the juicy appreciation gains. Consider that a move in yield by just one percentage point on 10-year bonds brings a gain of eight percentage points in appreciation.

Leveraged yield-curve playing is, of course, an old game in the world of finance. But outside the banking system it used to play a marginal role. This has its obvious main reason in the fact that recessions and periods of a positive yield-curve were of short duration, generally being followed by sharp cyclical recoveries and quick rate hikes.

Yield-curve playing proliferated for the first time in the early 1990s against the backdrop of the U.S. economy's slow recovery from the recession in 1991 and a prolonged period of low short-term interest rates — actually 3% from July 2, 1992, to May 17, 1994. A small rate hike by the Fed on that day was enough to prick the bubble and to shatter the bond market.

Consider the difference: This time the Fed's far lower federal funds rate of 1.25% has been in place for a year and a half, yet there is still no trace of a coming recovery in the most recent data. Instead, every bit of slightly positive news is cravingly grabbed and hailed as a bullish signal.

Just for fun, a case in point. On June 18, a headline in a world paper said: *"Dollar strengthens on economic report."* The article said, the dollar gained after the Federal Reserve said industrial production rose 0.1% last month after a 0.6% drop in April. For comparison the wording of the Fed report: *"Industrial production edged up 0.1% in May after having fallen 0.6% in both March and April. At 109.6% of its 1997 average, industrial output was 0.8% lower than at its level in May 2002."*

Another report said that consumer prices were unchanged in May; excluding food and energy costs, "core" prices rose 0.3%. This news was taken as bullish because it eased the concern about deflation. On the other hand, the unexpected but significant drop in the Michigan sentiment index was ignored, being attributed to the still soft job market.

This leapfrogging from one economic data to the next with a pronounced bias towards stressing good news is what passes today as economic discussion.

As to industrial output, please note that since 1997 it has risen by little more than 9%. By the way, this compares with a simultaneous increase in real domestic purchases by 21.2%.

THE NEXT BUBBLE TO BURST

Barron's June 16, 2003, issue carried exciting news on its first page: BULL RUN! This rally is for real. Even if a summer lull sets in, stocks are likely to be 10% higher by year-end. Credit rock-bottom interest rates, rising corporate profits and favorable tax policies.

As a matter of fact, the author's main source of moderate optimism for the stock market is not really because particularly positive expectations about the economy, but in the comparison with the extremely lousy rates that are obtainable in the bond and credit markets.

There is no joking about the gains in U.S. stocks since March 12. The Nasdaq index is up 30%, and the S&P 500 has risen 25%. Plainly, U.S. financial markets are in a good mood. Consensus economists of the financial community are unanimously forecasting the U.S. economy's impending recovery with growth rates in real GDP by 3–4% in this year's second half, and rising further in 2004.

Reading mostly bullish reports about the U.S. economy, it strikes us that they are all rich in optimistic assumptions and predictions, but very short on critical analysis of facts and causes. It is simply their foregone conclusion that the U.S. economy and its financial system are fundamentally sound. To make matters worse,

American policymakers and most economists mistake asset inflation for “wealth creation” and covet it rather than fear it.

Looking at the levels from where stock prices have come since the spring of 2000, the excitement about the rebound of the stock markets since March rather appears to us as too much ado about nothing. The truly decisive question is and remains, of course, the economy’s further performance.

As already mentioned, the actual economic data do not give the slightest reasons for expecting or predicting an imminent, strong recovery of the U.S. recovery. At the bottom of these optimistic forecasts is little more than the hope that the unusually aggressive measures undertaken by the government and the Federal Reserve will, after all, be effective in stimulating the economy.

For sure, America’s economy is at its most critical juncture. Hopes are riding high that the aggressive stimulative measures, implemented by the government and Federal Reserve, will not fail to revitalize it. Monetary and fiscal policies are operating with wide open spigots. Much smaller doses of both have always helped in the past. Why should these much bigger doses fail this time?

There is a simple answer: Past recessions were all chiefly caused by monetary tightening imposing a credit crunch on consumers and businesses. By easing credit, the central banks removed the recession’s cause, and basically healthy economies took off again.

For the first time ever in the postwar period, many countries around the world, not only America, are experiencing a prolonged economic downturn in the absence of any monetary tightening. In essence, there must be causes other than a credit crunch.

Nobody questions the need for action. But it should be clear that easy money can only be the cure for tight money, not for any other causes depressing the economy. For us, the real and disturbing story about the U.S. economy is that with all its imbalances it has reached the stage where it requires permanent, massive monetary and fiscal stimulus to garner just a tepid economic response — and to prevent the various bubbles from deflating. All this is definitely not prone to create a healthy economy being capable of self-sustaining growth.

The fundamental dilemma today is that the Greenspan Fed and Wall Street are making desperate efforts to sustain unsustainable bubbles. In the end, all bubbles are unsustainable because in order to stay afloat they have to inflate endlessly. Our greatest fear is now the bond bubble. Its influences are pervading the whole economy and the whole financial system, and its bursting may have apocalyptic consequences.

In our view, this bursting cannot be far away. To be sure, Mr. Greenspan will not prick it with a rate hike, but there comes a point where it simply peters out. Yield-curve playing aims at two different gains. What drives it is the differential between short-term and long-term rates. That has drastically shrunk; but its most attractive part is the big appreciation gains on the bond prices arising from the falling market yields.

With 10-year Treasury yields already down to almost 3%, there isn’t much room left for still lower yields and further appreciation gains. All that is needed to prick the bubble is for new buying to cease because long-term rates have become too low. Soon, more and more players will close their position, driving long-term rates upward. In the same vein, it has to be realized that the mortgage refinancing bubble does not depend on low interest rates, but on falling interest rates.

CONCLUSIONS:

Once more, America’s numerous consensus economists have convinced themselves that the U.S. economy is on the verge of the desired revival they are persistently forecasting. They enumerate two main reasons: first, better economic data, and second, stimulation of unprecedented magnitude — record-low interest rates, huge tax cuts and the falling dollar.

Just in early June, Mr. Greenspan told a banking conference in Berlin via satellite that there was still no evidence of a postwar acceleration in the U.S. economy. Most American economic data, labor market data in

particular, leave no doubt as to the direction of the economy's next major move — down, not up.

In the guise of fighting the evil of deflation, Mr. Greenspan has signalled to the markets his determination to accommodate the bond bubble as far as the eye can see.

But at the end of the day it all boils down to a judgment whether the overall stimulus will overpower the growth-choking imbalances and dislocations still in place from the past bubble excesses. For sure, the new stimulus is of unusually massive dosage, but so was the stimulus in 2002, with hardly any visible economic effect.

Instead of a healthy recovery, this massive stimulus created three new powerful bubbles: the bond bubble, the mortgage refinancing bubble and the house price bubble. But with bond yields at their present lows, these bubbles have largely spent their force.

Postwar recoveries from recession in the United States averaged 5.3% during the first two years. The domestic demand components that mainly drove them were bursts in residential construction and business investment in producers' durable equipment. There is zero chance for a recovery of such strength and this pattern.

After the sharp acceleration of the dollar's decline in recent months, it may now be oversold from a technical perspective. Despite a temporary retracement, it has much further to fall before a bottom is reached.

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